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IN THE

Supreme Court of the United States

No. 548. OCTOBER TERM, 1931.

JOSEPH S. MacLAUGHLIN, Collector of Internal Revenue For the First District of Pennsylvania,
Appellant,

v.

ALLIANCE INSURANCE COMPANY OF PHILADELPHIA,
Appellee.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR ALLIANCE INSURANCE COMPANY OF PHILADELPHIA, APPELLEE.

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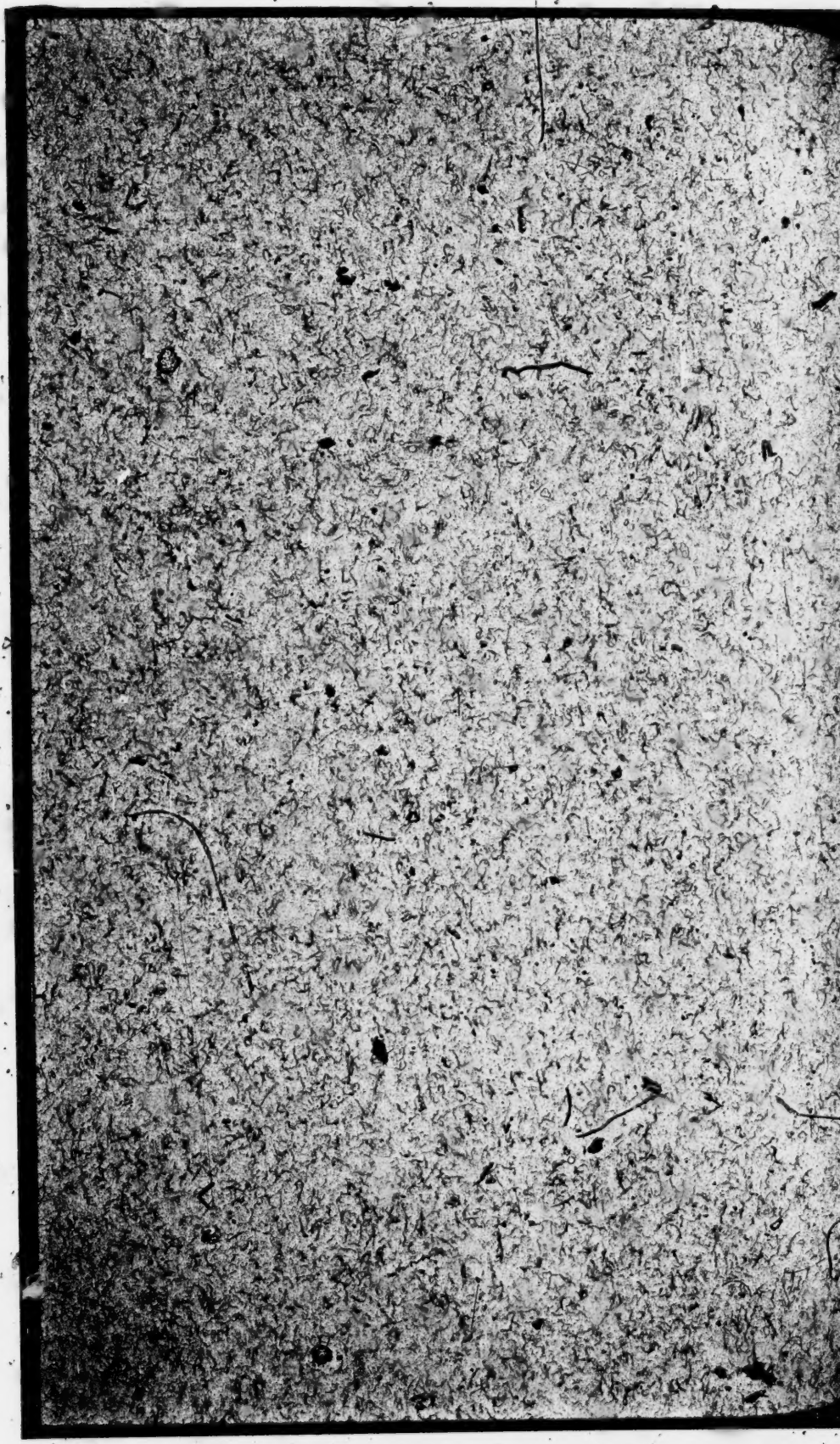

INDEX.

		PAGE
I.	THE OPINION OF THE COURT BELOW	1
II.	JURISDICTION	2
III.	QUESTION CERTIFIED	2
IV.	STATEMENT OF THE CASE	3
V.	SUMMARY OF THE ARGUMENT	3
VI.	ARGUMENT	5
	Statement of Appellee's Contention	8
	The power of Congress under the Sixteenth Amendment is only to lay a tax on income.	9
	The proper interpretation of Section 204 (b) (1) Clause (B) of the Revenue Act of 1928 is that the basis for determining gain from the sale or other disposition of property acquired before January 1, 1928 is the value of such property as of December 31, 1927	10
	The meaning of the word "income" in income tax acts is definitely settled by the decisions of this Court	30
	Any increased value that accrued before January 1, 1928, the effective date of the new clause in question, is capital and not income	31
	A reasonable construction should be adopted, which would uphold the Act	34
	Comments on Authorities relied on by Appellant	35
	Conclusion	44

AUTHORITIES AND STATUTES RELIED UPON.

Cases.

PAGE

Blodgett *v.* Holden, 275 U. S. 142 27

Bowers, Collector of Internal Revenue *v.* Kerbaugh Empire Co., 271 U. S. 170 30

Burnet, Commissioner of Internal Revenue *v.* Sanford and Brooks Company, 282 U. S. 359 32

Cooper *v.* United States, 280 U. S. 409 ..... 37, 38

Doyle, Collector of Internal Revenue *v.* Mitchell Brothers Co., 247 U. S. 179 ..... 32, 35, 40

Eisner *v.* Macomber, 252 U. S. 189 ..... 38, 39

Goodrich *v.* Edwards, 255 U. S. 527 36

Gould *v.* Gould, 245 U. S. 151 27

Hays, Collector of Internal Revenue *v.* Gauley Mountain Coal Co., 247 U. S. 189 32

Lynch, Collector of Internal Revenue *v.* Turrish, 247 U. S. 221 32

Merchants Loan & Trust Co. *v.* Smietanka, 255 U. S. 509 ..... 30, 42

Nichols *v.* Coolidge, 274 U. S. 531 ..... 27, 35

Panama Railroad Co. *v.* Johnson, 264 U. S. 375 35

Reinecke, Collector of Internal Revenue *v.* Northern Trust Company, 278 U. S. 339 34

Smietanka *v.* First Trust and Savings Bank, 257 U. S. 602 42

Southern Pacific Co. *v.* Lowe, 247 U. S. 330 ..9, 33, 34, 35

Taft *v.* Bowers, 278 U. S. 470 37

United States *v.* Jin Fuey Moy, 241 U. S. 394 34

Untermeyer *v.* Anderson, 276 U. S. 440 27

Statutes.

PAGE

Tariff Act of 1913, 38 Stat. 114, 173 ..... 5, 31, 33
Revenue Act of 1916, 39 Stat. 756 ..... 5, 31, 39
Revenue Act of 1917, 40 Stat. 300 ..... 5, 30, 31
Revenue Act of 1918, 40 Stat. 1057 5
Revenue Act of 1921, 42 Stat. 227 ... 5, 23, 30, 31, 38, 43
Revenue Act of 1924, 43 Stat. 253 ..... 5, 23, 31, 43
Revenue Act of 1926, 44 Stat. 9 ..... 5, 23, 31, 43
Revenue Act of 1928, 45 Stat. 791 .... 5, 9, 11, 13, 14, 23, 26, 29, 41, 44

Section 1 (26 U. S. C. A. Section 2001) 12
Section 4 (26 U. S. C. A. Section 2004) 10, 11, 21
Section 13 (26 U. S. C. A. Section 2013) ... 5, 13, 14, 15
Section 22 (26 U. S. C. A. Section 2022) 18, 22
Section 23 (26 U. S. C. A. Section 2023) ... 16, 18, 19, 20, 22
Section 65 (26 U. S. C. A. Section 2065) 12
Section 111 (26 U. S. C. A. Section 2111) 22
Section 112 (26 U. S. C. A. Section 2112) 22
Section 113 (26 U. S. C. A. Section 2113) . 8, 10, 11, 13, 19, 20, 22, 28, 29, 44
Section 117 (26 U. S. C. A. Section 2117) 41
Section 119 (26 U. S. C. A. Section 2119) 40, 41
Section 201 (26 U. S. C. A. Section 2201) ... 14, 15, 17, 40, 41, 43
Section 202 (26 U. S. C. A. Section 2202) 17, 43
Section 203 (26 U. S. C. A. Section 2203) 17, 43
Section 204 (26 U. S. C. A. Section 2204) .. 3, 4, 5, 7, 8, 10, 11, 14, 15, 17, 18, 19, 20, 21, 22, 25, 26, 27, 29, 31, 35, 40, 43, 44
Section 205 (26 U. S. C. A. Section 2205) 17, 21, 22, 41
Section 206 (26 U. S. C. A. Section 2206) 17, 21, 22
Section 207 (26 U. S. C. A. Section 2207) 17, 21, 22, 41
Section 208 (26 U. S. C. A. Section 2208) ... 14, 15, 16

IN THE

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OCTOBER TERM, 1931. No. 548.

Joseph S. MacLaughlin, Collector of Internal Revenue for the First District of Pennsylvania,
Appellant,

v.

Alliance Insurance Company of Philadelphia,
Appellee.

BRIEF FOR ALLIANCE INSURANCE COMPANY OF PHILADELPHIA, APPELLEE.

I. THE OPINION OF THE COURT BELOW.

The opinion of the District Court for the Eastern District of Pennsylvania, by Judge Kirkpatrick, is reported in 49 Federal Reporter (2d Series) 361.

The United States Circuit Court of Appeals for the Third Circuit, without deciding the case, has certified to this Court the question involved.

The opinion of the District Court, not being included in the Certificate, is set forth in full as Appendix A at the end of Appellant's brief filed in this Court in the companion case of The Insurance Company of the State of Pennsylvania *v.* MacLaughlin, No. 547, October Term, 1931.

II. JURISDICTION.

The question here presented has been certified to the Supreme Court of the United States by the Circuit Court of Appeals for the Third Circuit under the authority of Section 239 of the Judicial Code, as amended by the Act of February 13, 1925 (U. S. Code, Title 28, Section 346).

III. QUESTION CERTIFIED.

Under the Revenue Act of 1928, is the basis to be used by an insurance company (other than a life or mutual insurance company) in computing "gain during the taxable year from the sale or other disposition of property," acquired before and disposed of after January 1, 1928, its fair market value as of January 1, 1928, the effective date of the Act? (Cert., p. 3.)

IV. STATEMENT OF THE CASE.

A full statement of the case as certified by the Circuit Court of Appeals for the Third Circuit has been set forth in Appellant's brief and in the interest of brevity is not repeated at this point.

V. SUMMARY OF THE ARGUMENT.

From March 1, 1913, until January 1, 1921, gain which had accrued subsequent to the former date and had been realized in the taxable year by insurance companies was subject to income tax as in the case of all other corporations. Such gain, however, was omitted from the definition of gross income of life insurance companies and of insurance companies (other than life or mutual) in the taxing Acts from January 1, 1921, until January 1, 1928, the effective date of the Revenue Act of 1928. A change was then effected in respect to insurance companies (other than life or mutual) by an amendment to section 204 of the Act which provided that gross income should include "gain during the taxable year from the sale or other disposition of property." This amendment was suggested by Senator Reed of Pennsylvania in order that insurance companies (other than life or mutual) might be "put on the same basis" in this respect with mutual companies.

Section 204 of the Revenue Act of 1928 which governs the taxation of insurance companies (other than life or mutual) is self-sustaining insofar as the matters are concerned which it purports to cover,

except where there are express cross-references. There is no such cross-reference in Section 204 (b) (1) (B), which is the clause here under consideration. The Supplement is also silent as to how such gain shall be computed.

There is entirely absent from the Revenue Act of 1928 and from the legislative history of the present amendment any evidence of an intention on the part of Congress to penalize this type of insurance company by subjecting it to an income tax upon gain realized from the sale or other disposition of property during the taxable year, which had accrued five or ten years or even longer before the effective date of the Act on January 1, 1928. Even if such an intention had been clearly and unequivocally expressed in the Act, which it is not, it would have exceeded the power of Congress to levy such a tax for the reasons that to do so would tax capital under the guise of income and would levy a tax which by its terms is so arbitrary and capricious that its enforcement would amount to the deprivation of property without due process of law within the inhibition of the Fifth Amendment.

Under these circumstances, therefore, it is submitted that the reasonable construction to be accorded Section 204 (b) (1) (B) is that it subjects to taxation as income only such portion of the gain realized by insurance companies other than life or mutual during the taxable year as had accrued subsequent to January 1, 1928, the effective date of the Revenue Act of 1928.

VI. ARGUMENT.

The Revenue Act of 1913 and the subsequent Acts of 1916, 1917 and 1918 taxed all insurance companies in the same manner as corporations generally. Under these Acts gain which accrued subsequent to March 1, 1913, and was realized during the taxable year from the sale or other disposition of property was taxable as income. Under the Revenue Act of 1921, however, gain by insurance companies (other than mutual) from the sale or other disposition of property was no longer subject to tax, nor were said companies permitted to deduct losses sustained in like manner. The Revenue Acts of 1924 and 1926 re-enacted substantially the provisions of the Act of 1921 in this respect. Thus, from January 1, 1921, until January 1, 1928, insurance companies (other than mutual) were not subject to income tax upon gain derived from the sale or other disposition of property.

The Revenue Act of 1928, approved May 29, 1928, became effective as of January 1, 1928.

Section 13 of that Act imposes a tax of 12% upon the net income of corporations generally. Supplement G, which is composed of Sections 201 to 208, inclusive, dealing with insurance companies, provides by Section 204 (26 U. S. C. A. sec. 2204) as follows:

> "(*a*) In lieu of the tax imposed by section 13 of this title, there shall be levied, collected, and paid for each taxable year upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

"(1) In the case of such a domestic insurance company 12% of its net income; * * *.

"(*b*) Definition of income, etc. In the case of an insurance company subject to the tax imposed by this section—

"(1) Gross income.—'Gross income' means the sum of (A) * * *, and (B) gain during the taxable year from the sale or other disposition of property.

"(*c*) Deductions allowed.—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:

* * * * * * *

"(5) Losses sustained during the taxable year from the sale or other disposition of property; * * *."

The foregoing clauses, (b) (1) clause (B) and (c) (5), which provide for the inclusion in the definition of "gross income" of "gain during the taxable year from the sale or other disposition of property" and that "losses sustained during the taxable year from the sale or other disposition of property" shall be allowed as deductions in computing the net income of such insurance companies, are new.

The question of the proper construction of these new clauses of the Revenue Act of 1928 was first stated by the Bureau of Internal Revenue of the Treasury Department in Internal Revenue Bulletin Volume 7 No. 51, December 17, 1928, as follows:

"The question is presented relative to the basis to be used in computing gain or loss resulting from the sale or other disposition of property by insurance companies (other than life or mutual insurance companies) under section 204 of the Revenue Act of 1928.

"In defining the term 'gross income', clause (A) of section 204 (b) 1 of the Revenue Act of 1928, relative to investment income and underwriting income, is substantially the same as section 246 (b) 1 of the Revenue Act of 1926.

"Section 204 (b) 1 of the Revenue Act of 1928, however, contains a new provision, clause (B) which provides that gross income also includes 'gain during the taxable year from the sale or other disposition of property.' Section 204 (c) 5 is also new and provides that 'Losses sustained during the taxable year from the sale or other disposition of property' shall be allowed as deductions in computing the net income of such insurance companies. Inasmuch as these provisions in the Revenue Act of 1928 are new, the question is presented as to whether, in the case of property owned by such taxpayers on January 1, 1928, the basis to be used in computing gain or loss is the fair market value of the property on that date or whether the basis is that provided by section 113 of the Act."

The construction adopted by the Bureau of Internal Revenue was that:

"The basis to be used in computing gain or loss resulting from the sale or other disposition

of property by such insurance companies on or after January 1, 1928, under the provisions of Section 204 of the Act is the cost, the fair market value as of March 1, 1913, or other basis as provided by Section 113 of the Act, and not the fair market value as of January 1, 1928, the effective date of the Income Tax Act of 1928."

Statement of Appellee's Contention.

The appellee contends that the Bureau of Internal Revenue erred in the foregoing construction and that the proper construction of clause (b) 1 (B) of Section 204 of the Revenue Act of 1928 is that the basis to be used in computing gain resulting from the sale or other disposition during the taxable year 1928 of property acquired before January 1, 1928, by insurance companies (other than life or mutual insurance companies) is the fair market value thereof as of December 31, 1927, instead of the fair market value thereof as of March 1, 1913, or other basis as provided by Section 113 of the Act.

The refund which appellee seeks to recover is the amount of tax paid on alleged gain from the sale of property during the year 1928, in excess of the amount that would have been paid if the gain had been determined on the basis of the value of the property as of December 31, 1927, instead of on the basis of the value thereof as of March 1, 1913, or other basis as provided by Section 113 of the Act; in other words, the amount claimed is the amount of tax paid on value that accrued on capital assets before the effec-

tive date of the new clause during a long period of years, during which insurance companies (other than life or mutual) were not subject to a tax on such gain.

The power of Congress under the Sixteenth Amendment is only to lay a tax on income.

The validity of the Revenue Act of 1928, as the tax under it is not apportioned among the states, is derived from the Sixteenth Amendment. The title of the Sixteenth Amendment is "Income Tax," and the language used in the body of the Amendment states that the power given to Congress is "to lay and to collect taxes on incomes." Therefore to tax capital under the Revenue Act of 1928 is not within the power of Congress.

Under the Sixteenth Amendment for the first time Congress was empowered to tax income from property without apportioning the tax among the states according to population: **Southern Pacific Co. v. Lowe (1917) 247 U. S. 330, 335.** An interpretation of any part of that Act which would result in its taxing capital would render such part unconstitutional and void.

The Sixteenth Amendment is as follows:

"INCOME TAX.

"The congress shall have power to lay and collect taxes on incomes from whatever sources derived, without apportionment among the several states, and without regard to any census of enumeration."

The proper interpretation of Section 204 (b) (1) Clause (B) of the Revenue Act of 1928 is that the basis for determining gain from the sale or other disposition of property acquired before January 1, 1928, is the value of such property as of December 31, 1927.

It is submitted that Section 113, invoked by the Bureau, has no application to the new clause in Section 204 and that the purpose and intention of Congress was that the basis to be used in computing gain by insurance companies (other than life or mutual insurance companies) from the sale or other disposition of property acquired before January 1, 1928, should be the fair market value of the property as of December 31, 1927. Any other conclusion would render the clause unconstitutional and void on the ground that it would result in taxing as income that which is not income but increase of capital, and not subject to a tax as income, and on the further ground that it would levy a tax which by its terms is so arbitrary and capricious that its enforcement would amount to the deprivation of property without due process of law within the inhibition of the Fifth Amendment.

It is provided in Section 4 of the Act that special classes of taxpayers, among whom insurance companies are enumerated, specially dealt with in separate chapters which are designated "Supplements," shall not be subject to the application of provisions in the Act general in their nature, but that the

general provisions shall be subject to the exceptions and additional provisions found in the Supplements dealing with the special classes of taxpayers.

Section 4 provides as follows:

"SPECIAL CLASSES OF TAXPAYERS.

"The application of the General Provisions and of Supplements A to D, inclusive, to each of the following special classes of taxpayers, shall be subject to the exceptions and additional provisions found in the Supplement applicable to such class, as follows: * * *

"(c) Insurance companies,—Supplement G."

Section 113 is a part of Supplement B, which is thus subject to the exceptions and additional provisions found in Supplement G, relating to insurance companies, which includes Section 204.

The fact that the effective date of the new clause of Section 204 (providing for the inclusion within gross income of "gain during the taxable year from the sale or other disposition of property") is January 1, 1928, and that the provisions of the Revenue Act of 1928 are expressly made applicable only to the taxable year 1928 and succeeding taxable years make it manifest that gain during the taxable year from the sale or other disposition of property, was intended to be limited to that accruing on or after January 1, 1928, and thus that the clause in question constitutes an exception or additional provision to which Section 113 of the Act is subject, rather than the reverse.

Section 1 of the Act is as follows:

"APPLICATION OF TITLE.

"The provisions of this title (the Income Tax portion of the Revenue Act of 1928) shall apply only to the taxable year 1928 and succeeding taxable years. Income, war-profits and excess-profits taxes for taxable years, preceding the taxable year 1928 shall not be affected by the provisions of this title, but shall remain subject to the applicable provisions of prior revenue Acts, except as such provisions are modified by Titles III, IV, and V of this Act or by legislation enacted subsequent to this Act."

Section 65 is as follows:

"EFFECTIVE DATE OF TITLE.

"This title shall take effect as of January 1, 1928, except that Sections 146 and 151, and this section, shall take effect on the enactment of this Act."

The Act contains a number of general provisions prescribing the rate of tax, what is to be included in gross income, what is to be deducted therefrom in arriving at net income, the various credits to which certain classes of taxpayers are entitled, and the basis for determining gain or loss from the sale or other disposition of property, insofar as the taxation of corporations, partnerships and individuals in general, subject thereto, is concerned, all of whom since 1913 have not only been subject to

income taxes but to a tax on gain from the sale or other disposition of property. The basis for determining the gain or loss of such taxpayers is under Section 113.

In the various income tax acts, including the Revenue Act of 1928, Congress has recognized that because of the very nature of the insurance business it is necessary to treat life insurance companies and insurance companies (other than life or mutual) as special classes of taxpayers separate and distinct from corporations in general. This is necessary because of the difficulty of reflecting the true income of such companies. The practices of all insurance companies are different from those of an industrial corporation. Even the accounting terms have a technical meaning which would not be comprehensible to an expert accountant unless he had specialized in insurance accounting. Life insurance accounting is entirely different in character from that followed by fire insurance companies. Accounting practices of mutual companies are different from those followed by stock companies. To meet this situation, Congress has seen fit not only to segregate insurance companies from other corporations but to distinguish between life companies and companies other than life, and between stock companies and mutual companies, in the income tax laws, including the Revenue Act of 1928.

The tax on corporations in general is imposed by Section 13, but the tax on life insurance companies

and on insurance companies (other than life or mutual) is imposed by Sections 201 and 204 of Supplement G "in lieu of the tax imposed by Section 13 of this title." These words are indicative of the complete severance of these Sections of the Act from the general provisions thereof insofar as the matters covered by these Sections are concerned. It was not necessary for Congress to use the words "in lieu of the tax imposed by Section 13 of this title," the rate of tax under all three sections being identical, namely, 12%. The only possible reason for the use of this phrase was to emphasize the fact that Sections 201 and 204 imposing the tax upon insurance companies other than mutual companies are self-sustaining as to matters covered thereby.

This separate treatment of life insurance companies and insurance companies other than life or mutual is emphasized by the wording of Section 208 (a) of Supplement G dealing with mutual insurance companies other than life. Until the Act of 1928 there had been no separate clauses dealing with this kind of insurance company. Under previous acts a mutual insurance company other than life had simply been taxed under the general clauses covering other corporations. Mutual insurance companies other than life were first specifically mentioned in Section 208 of the Revenue Act of 1928. It is to be noted, however, that the theory upon which this section was drafted is entirely different from that followed in the drafting of the other sections of Supplement G

dealing with life insurance companies and insurance companies other than life or mutual. It is not attempted in Section 208 to set forth a detailed scheme of taxation applying to this type of company. It had evidently been found as a result of administering the income tax laws for fifteen years that mutual insurance companies other than life could with certain slight variations be treated under the general taxing provisions. As already stated, these variations are covered in Section 208 but in each instance this is accomplished by express reference to the general clauses of the Act applying to other corporations. Thus we find that instead of using the phrase "in lieu of the tax imposed by Section 13 of this title" as was done in Sections 201 and 204 applying to insurance companies other than mutual, Section 208 refers back to Section 13 which imposes the tax upon corporations in general, providing that "mutual insurance companies, other than life insurance companies, shall be taxable in the same manner as other corporations, except as hereinafter provided in this Section."

The intention to tax mutual insurance companies other than life "in the same manner as other corporations" is also evident from the other provisions of Section 208. Thus it is to be noted that Section 208 does not contain a complete definition of gross income of mutual companies. The definition of gross income set forth in sub-division (b) of Section 208 applies only to mutual *marine* insurance companies

and simply provides that "mutual marine insurance companies shall include in gross income the gross premiums collected and received by them, less amounts paid for reinsurance." Congress was obviously of the opinion that the gross income of mutual insurance companies in general requires no special treatment and can be accurately reflected by the application of the general clauses of the Act defining the gross income of taxpayers generally.

Moreover Section 208 (b) referring to the gross income of mutual marine insurance companies does not even contain a complete definition of gross income of such companies. It merely refers to a particular item which is to be "included" in their gross income.

The same applies to deductions which are provided for under sub-division (c) of Section 208 which provides: "*In addition* to the deductions allowed to corporations by Section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed." Thus the deductions allowed mutual insurance companies in general are to be found in Section 23 as in the case of all other corporations. In addition to such deductions Section 208 sets forth certain additional deductions to which certain types of mutual insurance companies are entitled.

Thus, all through Section 208 it is clearly the intention of Congress that mutual insurance companies other than life shall be taxed "in the same manner as other corporations," and the definitions

of gross income, of the deductions allowed, and of the rate of tax are all to be found in the general sections of the Act which apply to corporations in general. This treatment of mutual companies is in direct contrast to that afforded life insurance companies and insurance companies other than life or mutual under Sections 201 to 207 inclusive, which are obviously intended to be complete as to matters covered thereby.

It is contended by counsel for the Collector that the clauses requiring corporations to file returns, specifying the time for payment of tax, forbidding accumulation of surplus to avoid surtaxes, providing for the taxable period embracing years with different laws, and the other sections referred to on pages 14 to 17 of the Collector's brief, must be applicable to insurance companies (other than life or mutual) "for otherwise the Act would completely fail to provide for appropriate and necessary details as to administrative and many other matters relative to insurance companies." It is admitted that these general provisions of the Act do apply to such insurance companies, for the reason that Section 204 is complete only insofar as it purports to cover the matters specified therein, one of which is "gain during the taxable year from the sale or other disposition of property." Insofar as these matters are concerned, this section is exclusive of the general provisions of the Act except where they are incorporated by express reference. On the other hand,

when we come to matters which the section does not attempt to cover then we turn for guidance to the appropriate general sections.

A separate and complete definition of income, both gross and net, and a separate and complete statement of deductions allowed, as distinguished from the definition of income and a statement of deductions allowed in the case of corporations in general is included in Section 204.

Among other definitions in Section 204 are such phrases as "investment income," "underwriting income," "losses incurred," and "expenses incurred." All of these phrases have well recognized meanings in ordinary corporate accounting, but because of their technical meaning in insurance accounting the drafters of the Income Tax Act of 1928 considered it advisable to specifically define them in order to avoid any misunderstanding on the subject.

Section 204 contains certain references to the general provisions of the Act, in each instance, however, by specific reference. Thus we see that among the deductions allowed are:

> (1) All ordinary and necessary expenses incurred, as provided in Section 23 (a);
>
> (2) All interest as provided in Section 23 (b);
>
> (3) Taxes as provided in Section 23 (c);
>
> (7) The amount received as dividends from corporations, as provided in Section 23 (p);
>
> (8) The amount of interest earned during the taxable year which under Section 22 (b) 4 is

exempt from taxation under this title, and the amount of interest allowed as a credit under Section 26;

(9) A reasonable allowance for the exhaustion, wear and tear, as provided in Section 23 (k).

In other words, wherever it was intended that there should be a cross-reference to the general provisions of the Act, such cross-reference is specifically included in the language of Section 204.

It is to be noted that such cross-references are absent from the clauses here under consideration, namely, the definition of gross income contained in sub-division (b) 1 of Section 204, which provides:

"Gross income means the sum of (A) * * *, and (B) gain during the taxable year from the sale or other disposition of property,"

and the enumeration of deductions allowed, set forth in sub-paragraph (c) of Section 204 which provides that

"In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions: * * * (5) losses sustained during the taxable year from the sale or other disposition of property."

If Congress had intended that such gain and losses should be determined as provided in Section 113 of the Act, it would have been perfectly simple by the addition of a few words to the appropriate

clauses of Section 204 to have indicated its intentions in this regard.

The failure of Congress to do so is emphasized by the fact that such a cross-reference is contained in Section 23 of the Act, which is applicable to corporations, partnerships and individuals, in general. That section is headed "Deductions from Gross Income" and provides that "In computing net income there shall be allowed as deductions: (a) expenses; (b) interest; (c) taxes generally; (d) taxes of shareholder paid by corporation; (e) losses by individuals; (f) losses by corporations;" and under sub-section (g) that "The basis for determining the amount of deduction for losses sustained, to be allowed under sub-section (e) or (f), shall be the same as is provided in Section 113 for determining the gain or loss from the sale or other disposition of property." If Congress had intended that the loss to be deducted by insurance companies under Section 204 (c) 5 should be computed in acccordance with Section 113 of the Act as it intended with reference to subdivisions (e) and (f) of Section 23 of the Act, why did it not so specifically provide, as it was careful to do in Section 23 (g)? The obvious answer to this question is that Congress was fully conversant with the pertinent decisions of this Court and the distinctions there drawn between income and capital, and knew that it did not have the authority to tax as income accretions to capital assets which had accrued to insurance companies prior to the effective date of the new clauses of the Revenue Act of 1928.

Congress likewise knew that under the decisions of this Court it was without power to levy a tax which would be so arbitrary and capricious that its enforcement would amount to the deprivation of property without due process of law.

The statement of counsel for the Collector on page 17 of their brief that "Although there are in the sections relating to insurance companies *a few* references to the general provisions of the Act, the usual treatment seems to have been not to make reference to other provisions of the Act but rather to rely upon the introductory provisions of Section 4 * * *" is hardly accurate. The sections which apply particularly to insurance companies other than life or mutual are Sections 204 to 207 inclusive. Section 204 is divided into various sub-sections.

Thus, sub-section (a) imposes the tax of 12% "in lieu of the tax imposed by section 13 of this Title." Sub-section (b) contains definitions of gross and net income of such insurance companies. The contents of this sub-section are all matters peculiar to this type of insurance company and are not elsewhere covered in the Act, with the exception of the inclusion in gross income of "gain during the taxable year from the sale or other disposition of property." Obviously, therefore, there was no occasion to have cross-references in this sub-section to any other sections of the Act, except in connection with a definition of "gain," if such had been the intention of Congress. Sub-section (c) sets forth the deductions allowed. As

already stated there are ten sub-divisions of this sub-section. In seven of these sub-divisions there are cross-references to sections 22 and 23. Two of the sub-divisions are complete in themselves and require no cross-reference. The tenth sub-division allows as a deduction "(5) Losses sustained during the taxable year from the sale or other disposition of property" and contains no cross-reference. Sub-section (d) of section 204 contains a cross-reference. Sub-section (e) is complete. Sections 205, 206 and 207 all contain cross-references.

In other words, instead of saying as counsel for the Collector do that "There are *"a few* references to the general provisions of the Act" it would be more accurate to say that with the exception of the two clauses here under consideration there is a cross-reference in every single provision of the sections covering this type of insurance company which does not contain matter peculiar to such insurance companies, or which is not self-sufficient. The only possible conclusion, therefore, from the failure of Congress to insert a cross-reference after these new provisions is that it was not intended that gains of insurance companies should be computed in accordance with Sections 111-113 inclusive but that they should be computed on the basis of the effective date of Section 204 (b) (1) (B), in accordance with the existing law as set forth in the various decisions of this Court.

The reason for this distinction is obvious from

the history of the taxation of insurance companies under the various Revenue Acts. As already stated, all insurance companies were taxed in the same manner as other corporations from 1913 until 1921. In the administration of these earlier income tax Acts the Treasury Department had encountered serious difficulty in determining the true net income of certain kinds of insurance companies. It had been found that the general accounting methods applicable to other types of corporations were inadequate for such companies. Accordingly, in the drafting of the Revenue Act of 1921 life insurance companies and insurance companies other than life or mutual were segregated from other corporations in Sections 242 to 247 inclusive.

At the same time the definitions of gross income for such insurance companies as set forth in sections 244 and 246 of that Act did not include "gain during the taxable year from the sale or other disposition of property," nor did the deductions allowed such companies include losses so realized. This situation continued under the Revenue Acts of 1924 and 1926.

In the report, dated December 7, 1927, of the Ways and Means Committee of the House of Representatives, to which had been referred the Bill (H. R. 1, afterwards the Revenue Act of 1928) appears the following statement:

> "The bill embodies a proposed new arrangement for the income tax title. The basis for the arrangement is the distribution of the provisions

by two classifications: General Provisions and Supplemental Provisions. There are a few Introductory Provisions.

"*The General Provisions are those which apply to the ordinary transactions of the ordinary classes of taxpayers. It is believed that approximately 80 per centum of the taxpayers who file returns under the new Act will find in the General Provisions practically all the income tax statute law of interest to them.* The General Provisions are divided into Parts.

"The Supplemental Provisions comprise all provisions of the income tax title other than the General Provisions and the Introductory Provisions. *In the main, the Supplemental Provisions are those which apply only to extraordinary classes of taxpayers or which apply only to the extraordinary transactions of ordinary classes of taxpayers.* The Supplemental Provisions are divided into Supplements." (Italics ours.)

Thus, insurance companies were intentionally included in Supplement G because they are among the "extraordinary classes of taxpayers," to which the General Provisions were largely inapplicable.

When the Bill was before the Senate for consideration, Senator Reed of Pennsylvania called attention to the fact that while a mutual insurance company had to pay a tax on profits realized from its investments, stock companies were exempt. It was thereupon agreed that the Act should be amended so as to put insurance companies, other than life or mutual, "upon the same basis" in this respect as mutual

companies. To accomplish this the proposed Revenue Act of 1928 was appropriately amended by the insertion of the two clauses here under consideration so as to include in the gross income of such companies "gain during the taxable year from the sale or other disposition of property," and to allow as a deduction losses similarly sustained.

It is to be noted that in the legislative history of Section 204 (b) (1) (B) of the Revenue Act of 1928, which is set forth in full in Appendix C of the brief filed for the Collector at page 41, there is no indication of a desire on the part of Congress to penalize insurance companies other than life or mutual. Senator Reed simply called attention to the fact that under the existing law profits realized by mutual insurance companies were taxable, while those realized by companies other than life or mutual were not. By putting the two classes of companies "on the same basis" it was intended that after the effective date of the Revenue Act of 1928 insurance companies other than life or mutual should pay an income tax on profits accrued and realized after that date. Congress did not intend that when an insurance company, other than life or mutual, disposed of certain of its investments subsequent to January 1, 1928, it should be subject to the payment of an income tax upon the increment of such investments which might have entirely accrued five or ten years before the effective date of the Act, during seven years of which this gain from the sale or other disposition of property would have been exempt from taxation. To

have subjected them to a tax on such basis would not have been to put such companies "on the same basis" as mutual companies but to have penalized them to the great disadvantage of the thousands of policy holders and stockholders of such companies throughout the United States.

It is submitted that such an intention on the part of Congress must be clearly and unequivocally expressed before such a construction of a taxing statute is adopted by this Court. It is further submitted that clear and unequivocal evidence of such an intention is entirely lacking in the present instance.

The history of the Revenue Act of 1928 discloses that the Act was approved May 29, 1928, and became effective as of January 1, 1928; that for a period of seven years, gain from the sale or other disposition of property by insurance companies, other than life or mutual, had not been subject to income tax; that in the passage of the Act of 1928 attention was called to the fact that mutual insurance companies were subject to such a tax, whereupon the Act was amended and section 204 (b) (1) (B) was inserted. It is submitted that the construction contended for by the Treasury Department is unreasonable in that it is not justified by the terms of the Act itself, is arbitrary in that it subjects these insurance companies to an unwarranted hardship which was never contemplated by Congress, and which if persisted in will render this provision of the Act unconstitutional not only because it will attempt to

levy an income tax upon that which is capital but also because its enforcement would amount to deprivation of property without due process of law within the inhibition of the Fifth Amendment of the Federal Constitution. **Nichols v. Coolidge, 274 U. S. 531 (1927); Blodgett v. Holden, 275 U. S. 142 (1927); Untermeyer v. Anderson, 276 U. S. 440 (1927).**

It has been repeatedly held by this Court that "In case of doubt they (statutes levying taxes) are construed most favorably against the Government and in favor of the citizen." **Gould v. Gould, 245 U. S. 151 (1917).**

It is submitted that under the existing circumstances this Court should adopt a construction which both carries out the intention of Congress without undue hardship to the taxpayer and removes all doubt as to the constitutionality of the provision. This can only be done by holding that gain realized by insurance companies other than life or mutual during the taxable year shall be included in the gross income of such companies to the extent that such gain has accrued since January 1, 1928, the effective date of the Revenue Act of 1928.

Judge Kirkpatrick, in upholding the contention of the appellee in this connection, says (p. 27 of Appellant's Brief in Companion Case, No. 547):

> "The government's contention is simply that since there are no exceptions or additional provisions in Sec. 204 or, for that matter, anywhere in Supplement G, affecting the basis for deter-

mining gain or loss of stock fire, casualty or marine insurance companies, Sec. 113 was intended to apply and to furnish the basis. It is further argued that only by so holding can stock insurance companies of the classes referred to be placed upon a parity with mutuals, since the latter in case of property sold during 1928 must compute the gain on the basis of its 1913 value.

"But the statute (Title 1 of the Act) is an income tax law. The predominant intention running through all provisions is to tax income only. The Sixteenth Amendment is a grant of power to lay taxes upon incomes and the presumption is that Congress intended to act within its constitutional limits. Whatever may be read into the Act by implication must yield to a construction which will uphold the Act, unless a contrary intention is so clearly indicated as to make any other interpretation impossible with reason. This is the basis of the plaintiffs' position for they say that the construction contended for by the government would result in imposing a tax upon something not income at all but an accrual to capital matured before the passage of the Act.

"A review of decisions under the Corporation Excise Tax Act of 1909 sustains the plaintiffs' view."

And again (p. 35, Appellant's Brief, No. 547):

"Of course, if it appeared clearly and unequivocally from the terms of the Act of 1928 that Congress intended to apply the measure for

gains, provided for by Sec. 113, to insurance companies of the plaintiff's class the question of constitutionality would have to be met. But there are many things in the language and structure of the Act of 1928 which strongly suggest that Congress did not so intend and I cannot agree that the conclusion that Sec. 113 was intended to apply to the tax imposed by Sec. 204 (b) (1) (B) is necessary, or even permissible. The tax imposed by Sec. 204 is expressly stated to be 'in lieu of the tax imposed by Sec. 13 of this title.' Sec. 13 imposed a 12% tax on the net income of corporations generally which is the amount imposed by Sec. 204 and the effect of the phrase quoted above is to emphasize the intention to make Sec. 204, a scheme or code of taxation, complete in itself, applicable to insurance companies other than life or mutual without reference to the general provisions of the Act. No other reason can be suggested for providing that a tax of 12% should be 'in lieu of' a tax at the same rate already fixed for corporations generally.

"This intention appears more clearly when Sec. 204 is examined in all its parts. Whenever it was intended to incorporate into Sec. 204 any of the general provisions of the Act such provisions were specifically referred to and included by express language."

It is not to be presumed that Congress intended that the words used by it should be given a meaning not consonant with their recognized meaning, as established by the decisions of this Court.

The meaning of the word "income" in income tax acts is definitely settled by the decisions of this Court.

In the case of **Bowers, Collector of Internal Revenue v. Kerbaugh-Empire Co., 271 U. S. 170,** decided May 3, 1926, which presented a question arising under the Revenue Act of 1921, suit having been brought by the plaintiff to recover taxes assessed against it and paid under protest, this Court said (p. 174):

> "'Income' has been taken to mean the same thing as used in the Corporation Excise Tax Act of 1909, in the Sixteenth Amendment, and in the various revenue acts subsequently passed. Southern Pacific Co. *v.* Lowe, 247 U. S. 330, 335; Merchants' L. & T. Co. *v.* Smietanka, 255 U. S. 509, 519. * * *
>
> "In determining what constitutes income substance rather than form is to be given controlling weight. Eisner *v.* Macomber, *supra,* 206."

In the case of **Merchants' Loan & Trust Co. v. Smietanka, 255 U. S. 509,** decided March 28, 1921, involving the income tax Act of 1916, as amended by the Act of 1917 (p. 518):

> "It is obvious that these decisions (under the Corporation Excise Tax Act of August 5, 1909) in principle rule the case at bar if the word 'income' has the same meaning in the Income Tax Act of 1913 that it had in the Corporation Excise Tax Act of 1909, and that it has the same scope of meaning was in effect decided in Southern Pacific Co. v. Lowe, 247 U. S. 330,

335, where it was assumed for the purposes of decision that there was no difference in its meaning as used in the act of 1909 and in the Income Tax Act of 1913. There can be no doubt that the word must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the act of 1913 * * * there would seem to be no room to doubt that the word must be given the same meaning in all of the Income Tax Acts of Congress that was given to it in the Corporation Excise Tax Act and that what that meaning is has now become definitely settled by decisions of this Court."

Any increased value that accrued before January 1, 1928, the effective date of the new clause in question, is capital and not income.

As already stated, under the Income Tax Acts of 1921, 1924 and 1926, or in other words, from January 1, 1921, to January 1, 1928, Congress had seen fit to describe the gross income of insurance companies other than life or mutual as the "combined gross amount earned during the taxable year, from investment income and from underwriting income" as therein set forth. During this entire period gain realized by such companies from the sale or other disposition of property was not taxed. To give this new provision, clause (b) (1) (B) of Section 204 of the Revenue Act of 1928, the construction contended for by the Treasury Department would be to levy a tax upon gain which, although realized during the taxable year, had accrued over a period of

fifteen years prior to the effective date of the Act, during seven of which years such gain from the sale or other disposition of property was not subject to income tax.

It has been repeatedly held by this Court that such accretion to capital assets represents capital and not income, and is therefore not subject to tax as income.

These cases are set forth on pages 7 to 19 inclusive of Appellant's brief filed in this Court in the companion case of The Insurance Company of the State of Pennsylvania v. MacLaughlin, No. 547, October Term, 1931. For the sake of brevity these cases will not be repeated at this point.

Applying these authorities to the facts presented in the case at bar, we are led to the inevitable conclusion that the value of the capital assets of insurance companies (other than life or mutual) on December 31, 1927, represented capital and that upon the conversion of the same into cash at a subsequent date they were entitled "to have this capital restored," to apply the language of Mr. Justice Stone in **Burnet v. Sanford and Brooks Company, 282 U. S. 359,** "before there is a capital gain taxable as income," under the new provision of Section 204 of the Revenue Act of 1928.

Counsel for the Government in their brief attempt to minimize the effect of these authorities by arguing that the language quoted from **Doyle v. Mitchell Brothers, 247 U. S. 179; Hays v. Gauley Mountain Coal Co., 247 U. S. 189; Lynch v. Turrish, 247 U. S. 221,**

and **Southern Pacific Co. v. Lowe, 247 U. S. 330,** in the Appellant's brief filed in this Court in the companion case is mere dictum and that none of these cases holds that Congress cannot by an Act passed after the effective date of the Sixteenth Amendment require the inclusion in gross income of all gains which have accrued since that date.

Although the two cases first named involve the construction of the Corporation Excise Tax Act of 1909, and although March 1, 1913, happened to be approximately the effective date both of the Revenue Act of 1913 and the Sixteenth Amendment, these facts do not explain the repeated statement in those cases that accumulations that accrued to a corporation prior to the effective date of those Acts was capital and not income. While the Sixteenth Amendment was necessary to empower Congress to levy an income tax without apportionment among the States no constitutional amendment was needed in order to give Congress sufficient authority to levy an excise tax measured by income. It has been repeatedly held by this Court that the meaning of the word "income" is identical under the Excise Tax Act of 1909 and under the various Income Tax Acts beginning with that of 1913 and extending through that of 1928. When, therefore, in these earlier cases it was stated by this Court that accumulations to a corporation prior to the effective date of the Excise Tax Act of 1909 or of the Income Tax Act of 1913 represented capital and not income, it is submitted that those rulings have a direct bearing upon the question here

presented, that these cases speak for themselves, that the language used is unequivocal, and that when Justice Pitney says, in **Southern Pacific v. Lowe, supra,** that "We are bound to consider accumulations that accrued to a corporation prior to January (March) 1, 1913, as being capital not income," it represents the pronouncement of this Court on this subject, and until reversed must be regarded as the law of the land.

A reasonable construction should be adopted, which would uphold the Act.

Wherever clauses of an Act are susceptible of a reasonable construction to avoid unconstitutionality, such construction should be adopted. As stated in **Reinecke, Collector of Internal Revenue v. Northern Trust Company (1928), 278 U. S. 339,** at page 348, by this Court:

> "Doubts of the constitutionality of the statute, if construed as contended by the government, would require us to adopt the construction, at least reasonably possible here, which would uphold the act."

In **United States v. Jin Fuey Moy (1916), 241 U. S. 394,** Justice Holmes said, at page 401:

> "A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional but also grave doubts upon that score. United States *ex rel.* Atty. Gen. *v.* Delaware & H. Co., 213 U. S. 366, 408."

In **Panama Railroad Co. v. Johnson** (1924), 264 U. S. 375, 395, Justice Van Devanter said, at page 390:

> "But, as this court often has held, 'a statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional but also grave doubts upon that score.' United States *v.* Jin Fuey Moy, 241 U. S. 394, 401; United States *v.* Delaware & Hudson Co., 213 U. S. 366, 407, 408; Baender *v.* Barnett, 255 U. S. 224. The question arises, therefore, whether the statute is fairly open to such a construction."

It is submitted that the construction of Section 204 (b) (1) (B) of the Revenue Act of 1928 contended for by the Commissioner in the instant case would render that clause unconstitutional for the reasons that it would result in taxing capital under the guise of income, and that it would lay a tax so arbitrary and capricious that its enforcement would amount to deprivation of property without due process of law within the inhibition of the Fifth Amendment. **Doyle, Collector of Internal Revenue v. Mitchell Brothers Co., supra; Southern Pacific Co. v. Lowe, supra; Nichols v. Coolidge, supra.**

It is further submitted that in order to avoid grave doubts upon the question of the constitutionality of this provision the reasonable construction contended for by the Appellee should be adopted by this Court.

Comments on Authorities Relied on by Appellant.

On page 24 of their brief, counsel for the Collector refer to a number of cases decided by this Court for

the proposition that "gains on the sales of securities may be subject to income tax under the Sixteenth Amendment." This proposition of law has been so frequently decided that it requires no further comment than to say that it is without application to the question presented in the instant case.

At the top of page 26 of the Collector's brief, it is stated "In many of these cases it seems to have been assumed, at least by this Court, that Congress could tax all of such gain without deduction of that part of it which was attributable to accretions prior to the effective date of the applicable Act," citing certain authorities. It is submitted that an examination of these authorities shows very clearly that no such assumption can be attributed to this Court.

The first case relied upon by the Collector is *Goodrich* v. *Edwards,* 255 U. S. 527. Two transactions were involved in that case. In the first the plaintiff in error in 1912 purchased certain shares of stock for $500. This stock was worth $695 on March 1, 1913, and was sold in March, 1916, for $13,931.22. The income tax was assessed on the difference between the value of the stock on March 1, 1913, and the amount for which it was sold. This procedure was obviously correct and was held to be so by this Court.

In the other transaction the securities in question originally cost the taxpayer $291,600. On March 1, 1913, the value of this stock was $148,635.50. It was sold in 1916 for $269,346.25. Although it was thus apparent that the stock involved was of less value on

March 1, 1913, than when it was acquired and that it was ultimately sold at a loss to the owner, nevertheless the Collector assessed the tax on the difference between the value on March 1, 1913, and the amount for which it was sold. In the argument in this Court the Government confessed error in the judgment entered in its favor with respect to this assessment. This Court held that the word "gain" as used in the Income Tax Acts meant an actual gain to the taxpayer in excess of cost and not simply with reference to an arbitrary date, in this instance March 1, 1913. There having been no actual gain in this instance, the judgment of the District Court in this respect was reversed.

The mere statement of the facts involved in this case conclusively proves that it has no direct bearing upon the question here presented.

Taft v. *Bowers,* 278 U. S. 470 and *Cooper* v. *United States,* 280 U. S. 409, are also relied upon by counsel for the Commissioner. These cases both involve the taxability of profits derived by the donee as represented by the difference between the cost of the property in question to the donor and the price realized by the donee. These cases also have nothing to do with the question involved in this case of whether the increment accrued prior to December 31, 1927, to insurance companies (other than life or mutual) represents income or capital.

In the case of *Taft* v. *Bowers, supra,* the decision was simply that Congress had power to require that

for purposes of taxation the donee should accept the position of the donor in respect to the thing received; that the donee simply stepped into the shoes of the donor, in respect to taking the property subject to the burden of the income tax law as in other respects.

This Court very properly refused to give its sanction to the argument which, if adopted, would have made easy the evasion of tax liability on property previously impressed with such liability in favor of the Government.

As said by this Court in that case (p. 482):

> "Could he, contrary to the express will of Congress, by mere gift enable another to hold this stock free from such right, deprive the sovereign of the possibility of taxing the appreciation when actually severed, and convert the entire property into a capital asset of the donee, who invested nothing, as though the latter had purchased at the market price? And after a still further enhancement of the property, could the donee make a second gift with like effect, etc.? We think not."

In the case of *Cooper* v. *United States, supra,* this Court held that the gift provision of the Revenue Act of 1921 is not unconstitutional because it requires gains from transactions, completed prior to the passage of the Act but within the taxable year, to be treated as part of the donee's gross income.

On page 26 of their brief counsel for the Commissioner set forth an excerpt from the opinion of this Court in *Eisner* v. *Macomber,* 252 U. S. 189, 212. In

passing upon the question of whether stock dividends constituted income and were therefore subject to the Income Tax Act of 1916 this Court, speaking through Justice Pitney, said:

> "It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and *so far as it may have arisen since the Sixteenth Amendment* is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. (Italics ours.)"

In this connection it must be remembered that the taxpayer in *Eisner* v. *Macomber, supra,* was an individual who had at all times been subject to a tax upon capital gains since the effective date of the earliest of the modern Income Tax Acts, March 1, 1913. Therefore, as limited to such a taxpaper this language correctly sets forth the law as laid down by this Court.

As so frequently happens, however, when one or two sentences are taken out of their context, the language is misleading. The true position of the Court in that case can only be gathered by a study of the entire opinion. This excerpt must therefore be considered in conjunction with the definition of income set forth on page 207:

> "'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained

through a sale or conversion of capital assets, *to which it was applied in the Doyle case.* (Italics ours.).

The Doyle case referred to by Justice Pitney is the case of **Doyle, Collector of Internal Revenue v. Mitchell Brothers Co. supra,** in which it was decided by this Court that under the Corporation Excise Tax Act of 1909 the tax was to be measured only by that portion of the gain realized by the taxpayer from the conversion of capital assets during the taxable year, which had accrued subsequent to January 1, 1909, the effective date of the Act. In that case this Court expressly held that the increment which had accrued to such capital assets between the date of purchase and December 31, 1908, when realized, constituted capital and not income.

A full discussion of this case is set forth on page 7 of the brief filed in this Court in the companion case of The Insurance Company of the State of Pennsylvania, Appellant, *v.* MacLaughlin, Appellee, No. 547, October Term, 1931.

On page 16 of their brief counsel for the Collector attempt to draw some comfort from the fact that Section 207 provides: "The gross income of insurance companies subject to the tax imposed by Sections 201 or 204 shall *not* be determined in the manner provided in Section 119," from which they attempt to argue that in spite of the complete definition of gross income of insurance companies other than life or mutual set forth in Section 204 (b) it was necessary

to specifically provide that gross income of such companies should not be determined in the manner provided in Section 119 because otherwise Section 119 being a general clause would have applied to this type of company. It is submitted that the explanation of Section 207 is that it was inserted by the draftsman out of an excess of caution.

The same thing applies to Section 205 dealing with net losses. This Section provides: "The benefit of the special deduction for net losses allowed by Section 117 shall be allowed to insurance companies subject to the tax imposed by Sections 201 or 204, under regulations prescribed by the Commissioner with the approval of the Secretary."

If the argument of counsel for the Collector is sound with reference to Section 207 then the insertion of Section 205 was unnecessary because being a general section Section 117 would have applied to insurance companies other than mutuals without the express reference contained in Section 205. In other words, Sections 205 and 207 are of no assistance whatever in determining the question here presented and the explanation for their inclusion in the Act is that the draftsman inserted them out of an excess of caution, in the one case to show that Section 119 did not apply and in the other case to show that Section 117 did apply.

Counsel for the Collector attempt to belittle the construction contended for by Appellee by the use of the adjectives "unreasonable" and "novel," stating

at page 24 that "apparently it has never occurred to anyone except those now attacking the 1928 Act, that the contention here made was worth making." Of course, the obvious answer to such a statement is that this case is sui generis, that its facts are peculiar, and have never been involved in any other case in this Court.

In the argument in the District Court and in the Circuit Court of Appeals, counsel for the Collector relied primarily upon two cases: *Smietanka* v. *First Trust & Savings Bank,* 257 U. S. 602 (1921), and *Merchants Loan & Trust Co., Trustee* v. *Smietanka,* 255 U. S. 509 (1920), which they contended controlled the present case. The mind of counsel has apparently been disabused in this respect by the very adequate treatment of these two cases by the District Court in its opinion. In their present brief they refer only in passing to Merchants Loan & Trust Co., Trustee *v.* Smietanka, *supra,* in a note at the bottom of page 24. At the end of their brief, on page 29, counsel admit that "the point (here presented) seems not to have been raised" in that case.

The point not only was not raised in that case, but upon analysis the case is clearly distinguishable upon its facts. The discussion of these decisions by the District Court in its opinion is set forth on page 31 of the Appellant's brief filed in this Court in the companion case of The Insurance Company of the State of Pennsylvania *v.* MacLaughlin, No. 547, October Term, 1931.

As already stated, so far as we know no case

has ever arisen in this Court involving the facts here presented. A similar case might arise in the future involving a life insurance company which, under the Revenue Act of 1928, is taxable under Sections 201 to 203 inclusive. Life insurance companies like insurance companies other than life or mutual were taxable with respect to gains realized from the sale or other disposition of property from 1913 until 1921. In the drafting of the Revenue Act of 1921 the definition of the gross income of both life insurance companies and insurance companies other than life or mutual excluded gains. This situation continued under the Revenue Acts of 1924 and 1926 until 1928 when as a result of the Reed amendment the gains realized by insurance companies other than life or mutual were again included in the definition of the gross income of such companies. The provisions, however in the 1928 Act referring to life insurance companies remained substantially the same in the 1928 Act as in the preceding Acts of 1926, 1924 and 1921, with the result that such gains by life insurance companies are still not subject to tax.

If the construction of Section 204 (b) (1) (B) of the 1928 Act, contended for by the Collector, is adopted by this Court and is held to be constitutional, it would mean that the present situation with reference to the non-taxability of such gain by life insurance companies might continue for an unlimited period and then at the election of Congress at some future date twenty-five, fifty or even one hundred years from now, Congress could adopt a new Income Tax Act which would tax the gain of life insurance companies realized during the taxable year which

had accrued from January 1, 1913, although during all of these years such increment, if realized, would not have been taxed and would have been regarded by such companies as a part of their capital.

CONCLUSION.

The conclusion inevitably reached is that the gradual advance in the value of property of insurance companies (other than life or mutual) before January 1, 1928, the effective date of the new clause of Section 204 of the Revenue Act of 1928, when converted, in no just sense constitutes gain from the sale or other disposition of property during the taxable year 1928, and that, in view of the treatment of insurance companies as a special class of taxpayer and of the well-established doctrine that Congress is presumed to have legislated with a constitutional intent, such previously accrued value was not intended by Congress to be considered income. It constitutes and can be treated only as increase of capital.

It follows that the action of the lower court in holding that the basis to be used in computing gain resulting from the sale or other disposition of property by insurance companies (other than life or mutual) on and after January 1, 1928, is the fair market value as of December 31, 1927, and not the fair market value as of March 1, 1913, or other basis as provided by Section 113 of the Act was proper, and that the question certified in this case should be answered in the affirmative.

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